

**The Internal Revenue Service Is Addressing
the Use of the Illegal Tax Protestor and
Nonfiler Designations**

September 1999

Reference Number: 199910080

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 30, 1999

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Is Addressing
the Use of the Illegal Tax Protestor and Nonfiler Designations

This report presents the results of our review of the Internal Revenue Service's (IRS) compliance with the IRS Restructuring and Reform Act, Pub. L. No. 105-206, 112 Stat. 685 (1998) (referred to as RRA 98) to stop designating taxpayers as Illegal Tax Protestors (ITP) by removing the ITP designation from its main computer files, and disregarding it in documents.

In summary, we found that the IRS has taken actions and is substantially in compliance with the RRA 98 as it relates to no longer designating taxpayers as Illegal Tax Protestors (ITP), removing the ITP designation from the Individual Masterfile, and disregarding the ITP designation made on or before July 22, 1998, on other IRS computer and paper files. Also, the IRS has various nonfiler programs to determine if taxpayers are filing returns. However, we were advised by IRS programmers that none of these programs designate taxpayers permanently as nonfilers on IRS' main computer files and, therefore, are not applicable to this RRA 98 provision.

We recommended the IRS continue to monitor the actions in process to fully comply with the provisions of the RRA 98. Also, IRS management should monitor the planning and implementation of the newly proposed program of frivolous nonfiler designations to ensure it meets the intent of the RRA 98, when implemented.

IRS management agreed with the issues included in this report and is planning to take corrective actions. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have any questions, or your staff may call Maurice S. Moody, Associate Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Executive Summary

In the past, the Internal Revenue Service (IRS) referred to taxpayers as Illegal Tax Protestors (ITP) if they objected to, or refused to file required tax returns and/or pay taxes for insufficient reasons that were not supported by tax law. This ITP designation often became a permanent mark on the taxpayers' records in the IRS' main computer files. The Congress was concerned that some taxpayers may have been mislabeled by this designation.

The IRS used the ITP designation to accelerate collection activity and alert IRS employees that there might be problems encountered when dealing with the taxpayer. The IRS also monitored these taxpayers' accounts to determine if the taxpayer filed tax returns and paid his/her tax liabilities.

The Restructuring and Reform Act, Pub. L. No. 105-206, 112 Stat. 685 (1998) required IRS employees to stop designating taxpayers as ITPs or any similar designation. (Future references to this law will be to the law in general and will be referred to as RRA 98.) The RRA 98 also required the IRS to remove the existing ITP designations from taxpayers' accounts on its main computer files beginning January 1, 1999, and disregard the ITP designation placed on any other IRS computer or paper files. However, the RRA 98 does authorize the IRS to continue designating taxpayers as nonfilers if they did not file required tax returns. Once the taxpayer files valid tax returns for two consecutive years and pays all taxes shown on the returns, the IRS is required to remove any nonfiler designation from its main computer files.

The RRA 98 added 26 U.S.C. § 7803(d) (1986), which requires the Treasury Inspector General for Tax Administration to evaluate whether the IRS is in compliance with the RRA 98 requirements regarding ITP and nonfiler designations. Our objective was to evaluate the IRS' compliance with the RRA 98 requirements to stop designating taxpayers as ITPs.

Results

The Internal Revenue Service Has Taken Actions to Comply with the Restructuring and Reform Act of 1998

The IRS removed the ITP designation from its main computer files. Also, in the eight IRS field offices we visited, employees were, in most instances, ignoring ITP designations on other IRS computer and paper files.

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In addition to the RRA 98 requirements, the IRS took the initiative to identify further actions that could be taken to ensure taxpayers are not labeled as ITPs. For example, the IRS issued additional written guidelines which detailed actions employees should take regarding ITP designations, formed a task force to oversee the implementation of the specific RRA 98 provisions, and appointed an executive to provide management oversight to ensure the RRA 98 requirements were met.

Although the IRS has taken actions to comply with the RRA 98, our review showed that IRS management should concentrate on the following actions regarding ITPs and taxpayer designations.

The Internal Revenue Service Should Ensure the Few Remaining Illegal Tax Protestor Designations Are Removed From Reference Manuals and Various Other Computer Systems

The IRS Internal Revenue Manual (IRM) contains the instructions and procedures for employees and managers to follow while performing their work duties. Also, the handbook, *ADP and IDRS Information* (Document 6209), contains explanations of computer terms relating to computer programs and taxpayers' records on IRS' main computer files and various other IRS computer systems.

We looked for references to the ITP designation in all IRM sections located on the IRS Intranet, as of April 1999, and in the latest version of the Document 6209, dated January 1999. We identified 65 sections in the IRM where the terms "protestor," "tax protestor," or "ITP" were used. We also identified several references to tax protestor terms in the Document 6209. Program analysts informed us that they have submitted requests to IRS Publishing Services and IRS Information Systems Division to remove these ITP designations from the IRM and Document 6209. They also provided written documentation to support that many of the changes were made. Timing may be the primary cause the IRM on the Intranet and Document 6209 have not been updated.

We also reviewed various IRS nationwide computer systems for references to ITP codes in several IRS field offices. In most cases, the ITP designations were removed. However, we identified isolated records that contained references to the ITP designation on some of these systems. We brought these records to IRS management's attention and they immediately removed the ITP designations.

The Internal Revenue Service Should Ensure the Newly Proposed Designations for Frivolous Nonfilers Will Comply with the Restructuring and Reform Act of 1998

The IRS has various nonfiler programs to determine if taxpayers are filing returns. However, we were advised by IRS programmers that none of these programs designate

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taxpayers permanently as nonfilers on IRS' main computer files and, therefore, are not applicable to this RRA 98 provision. Currently, the IRS places a code (repeater code) on its main computer files for taxpayers who do not file returns or pay taxes for more than one tax period. The IRS' procedures are designed to automatically remove the repeater code once the taxpayer has filed and paid all of his or her taxes for two consecutive years. Due to the magnitude of this program, our scope of work did not include verifying whether the automatic removal process was working effectively. However, we are planning a separate audit of the effectiveness of the repeater code removal process as part of our Fiscal Year 2000 Audit Plan.

The IRS is developing a program (Frivolous Return Program) designed to identify those taxpayers who intentionally do not file returns, or file substantially incorrect returns and give a frivolous argument for not filing an acceptable tax return. An example of a frivolous argument would be that salaries and wages are not income within the meaning of the Sixteenth Amendment to the United States Constitution, which grants the Congress the power to collect taxes.

This program has not been implemented yet and, at the time of this audit, only the initial plans were available for our review. We are planning to evaluate the program once it is implemented to determine if it meets the intent of the RRA 98.

The current plans for this program are to designate these taxpayers as frivolous nonfilers based on the specific reason the taxpayers use for failing to comply with their tax return filing requirements. The IRS previously identified 28 reasons or arguments that these taxpayers commonly use for not filing an acceptable tax return. The Tax Court has ruled that these arguments are not legitimate reasons for not filing tax returns. The proposed, new designation could be an effective use of IRS resources because it will address trends in non-compliance among these taxpayers and identify non-filing schemes. The current plans include the IRS developing education tools to explain to this taxpayer population why their reasons for not filing are not legitimate.

While we could not review the program at this time, the plans for designating taxpayers as frivolous nonfilers could be seen as being similar to the ITP designation. The IRS should closely monitor the further development and implementation of these designations to ensure that innocent taxpayers are not erroneously labeled. The IRS should also ensure that the planned computer monitoring program for these frivolous nonfiler designations is implemented. This computer monitoring program would automatically remove the frivolous nonfiler designation once the taxpayer files valid tax returns and pays all taxes shown on the returns for two consecutive years. The computer monitoring program is planned for implementation in the year 2000.

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Summary of Recommendations

We recommend the IRS monitor the remaining changes to remove the ITP designations from the IRS instruction manuals and from various IRS computer systems. Also, we recommend the IRS monitor the planning and implementation of the newly proposed frivolous nonfiler designations and the frivolous nonfiler computer monitoring program to ensure they meet the intent of the RRA 98.

Management's Response: IRS management agreed with the recommendations. All IRS offices have been asked to certify that ITP designations have been removed or destroyed by September 30, 1999. IRS plans to remove all references to ITPs and tax protestors found in the IRM on the Intranet and in printed materials. Implementation efforts are continuing for the Frivolous Return Program and are available for review, and IRS is still finalizing decisions to consolidate Service Center program activities into one location. Management's complete response to the draft report is included as Appendix IV.

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Objective and Scope

We evaluated the IRS' compliance with the RRA 98 to stop designating taxpayers as Illegal Tax Protestors (ITP) by removing the ITP designation from its main computer files, and disregarding it in documents.

The overall objective of the review was to evaluate the Internal Revenue Service's (IRS) compliance with the provisions of the Restructuring and Reform Act, Pub. L. No. 105-206, 112 Stat. 685 (1998) to stop designating taxpayers as Illegal Tax Protestors (ITP). (Future references to this law will be to the law in general and will be noted as the RRA 98.)

More specifically, we determined whether the ITP designation was:

- Removed from the IRS' main computer files.
- Disregarded by employees in the IRS field offices.

We also determined whether any nonfiler or new taxpayer designations were being monitored to ensure that they met the intent of the RRA 98.

We conducted our audit in the Houston, Manhattan, Midwest, Northern California, and Virginia-West Virginia District Offices; the Service Centers in Andover; Cincinnati, and Ogden; the four IRS Regional Offices; and the IRS National Office. Our audit was performed between January 1999 and May 1999, in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The RRA 98 added 26 U.S.C. § 7803(d) (1986), which requires the Treasury Inspector General for Tax Administration to evaluate whether the IRS is in compliance with the requirements regarding ITP and nonfiler designations.

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The Congress was concerned about taxpayers being labeled as ITPs by the IRS.

Over the years, the IRS has had a policy of referring to taxpayers as ITPs if they objected to, or refused to file required tax returns and/or pay taxes for insufficient reasons that were not supported by tax law (e.g., an argument that salaries and wages are not income, or income is not taxable because of the declining fair market value of the dollar). The IRS used the ITP designation in its main computer files to accelerate collection activity and alert IRS employees that there might be problems encountered when dealing with these taxpayers. The IRS also monitored these taxpayers' accounts to determine if the taxpayers filed tax returns and paid their tax liabilities.

The Congress had the following concerns regarding the ITP designation:

- Taxpayers were labeled as ITPs without regard to their filing obligation or compliance.
- The Congress saw the term "Illegal Tax Protestor" as bad policy when referring to a taxpayer.
- Labeling taxpayers as ITPs biased the IRS employee working the case, and may have resulted in unfair treatment to the taxpayer.
- ITP indicators were not always reversed when taxpayers became compliant with their tax obligations.

The RRA 98 required IRS to:

- *Stop designating taxpayers as ITPs.*
- *Remove the existing ITP designation from its main computer files.*
- *Disregard the ITP designation placed on other computer or paper files.*

The specific section of the RRA 98 referring to ITP designations is Pub. L. No. 105-206, 112 Stat. 685 § 3707 (1998). (Future references to this section will be noted as RRA 98 § 3707.) The RRA 98 § 3707 required IRS employees to stop designating taxpayers as ITPs or any similar designation. The RRA 98 § 3707 also required the IRS to remove the existing ITP designations from taxpayers' accounts on its main computer files beginning January 1, 1999, and disregard the ITP designation placed on any other IRS computer or paper files. However, the RRA 98 § 3707 does authorize the

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IRS to continue to designate taxpayers as nonfilers if they did not file the required tax returns. Once the taxpayer files valid tax returns for two consecutive years and pays all taxes shown on the returns, the IRS is required to remove any nonfiler designation from its main computer files.

IRS management in six of the field offices we visited had received only

after

July 22, 1998.

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Results

The IRS has taken actions and is substantially in compliance with the RRA 98 § 3707 regarding ITPs. However, we identified the following two areas that need continued IRS management attention:

- The IRS should ensure the few remaining ITP designations are removed from reference manuals and various other computer systems.
- The IRS should ensure the newly proposed designations for frivolous nonfilers will comply with the RRA 98.

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The Internal Revenue Service Has Taken Actions to Comply with the Restructuring and Reform Act of 1998

The IRS took actions such as issuing supplemental written instructions to employees, forming a task force, and assigning an executive to oversee implementation of the RRA 98 § 3707 changes.

To comply with the RRA 98 regarding the ITP designation of taxpayers, the IRS has taken actions to instruct employees on the RRA 98 § 3707 provisions and has provided oversight to implement the instructions. For example, the IRS issued written guidelines to employees that included instructions on what actions employees needed to take to meet the provisions of the RRA 98 § 3707. Also, the IRS established a Task Force Committee and appointed an executive to oversee the implementation of these actions. Some of the specific actions taken included:

- Removing the ITP designation from the main computer files.
- Stopping the practice of referring to taxpayers as ITPs, ignoring the ITP designation in documents, and not including it in correspondence.
- Requesting data shared on ITPs with state agencies be returned and destroyed.

Removing the ITP Designation From the Main Computer Files

Our analysis of all taxpayers' accounts on the IRS' main computer files showed there were approximately 57,000 accounts with an ITP designation in December 1998. Our analysis of the computer files after January 15, 1999, determined that only 1 [REDACTED] remained. Further research showed that the IRS programmers identified the problem during their own quality check and subsequently removed the indicators on the computer system. The reason the [REDACTED] 1 [REDACTED] was due to a timing issue related to the date they were input to the

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system and the date of the removal of the ITP designations.

We also determined that the cases with ITP designations were not simply reclassified into another program that identifies taxpayers as potentially dangerous (Potentially Dangerous Taxpayer (PDT) Program). The IRS' main computer files showed that there were approximately 7,100 PDT accounts as of December 27, 1998. We found no substantial increase in the number of accounts on the database as of January 24, 1999.

We performed additional research to determine if there were a large number of requests received around the January 1999 time frame to add names of PDTs to the National Employee Protection Coordinator (NEPC) database. The NEPC is responsible for managing the PDT Program, which includes evaluating final PDT determinations made by IRS management (along with IRS Chief Counsel), maintaining a PDT database, and adding and removing PDT designations from taxpayers' accounts on IRS' main computer files. The NEPC informed us there were not a large number of requests received during January 1999.

Stopping the Practice of Referring to Taxpayers as ITPs, Ignoring the ITP Designation in Documents, and Not Including it in Correspondence

Discussions with 112 IRS management officials and 11 employees in the 8 IRS field offices we visited showed that they were aware of the RRA 98 § 3707 requirements. Also, IRS management provided training or briefings to their employees on the provisions of the RRA 98, including the provision relating to ITPs.

To further determine if employees were disregarding the ITP designations, we reviewed a judgmental sample of taxpayer files in six IRS field offices. In our review of 254 taxpayer case files, of which 203 were previously designated as ITP cases, we found that 96 percent of the cases had no mention by employees of the ITP

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designation after July 22, 1998. The files where employees had noted “ITP” or “protestor” were brought to management’s attention in those offices for appropriate action. The majority of the employees in the offices we visited understood the new requirement for ignoring previous ITP designations and not noting it on written documents, such as taxpayer files or letters.

Requesting Data Shared on ITPs with State Agencies Be Returned and Destroyed

In three of eight IRS field offices we visited, the IRS had agreements with state agencies to share ITP data. Two of these offices exchanged ITP data after the date of the enactment of the RRA 98 § 3707. At the time of our review, one field office had requested the state agency to return the ITP data. The remaining field office was still exchanging ITP data with the state and had not requested the shared data be returned. In addition, there was no amendment to the agreement with the state agency to comply with the RRA 98 § 3707. This office has since taken steps to request the shared data be returned.

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IRS’ Instruction and Reference Manuals

The Internal Revenue Manual (IRM) contains instructions and procedures for employees and managers to follow while performing their official duties. Also, the handbook, *ADP and IDRS Information* (Document 6209) contains explanations of computer terms relating to computer programs and taxpayers’ records on the IRS’ main computer files and various other computer systems.

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References to ITPs remain in two of the IRS' main instruction manuals for employees. We were informed that requests to update these documents and remove the ITP references were submitted.

We looked for references still being made to the ITP designation in all IRM sections located on the IRS Intranet as of April 1999, and in the latest version of the Document 6209, dated January 1999. We identified 65 sections in the IRM where the terms "protestor," "tax protestor," or "ITP" were used. We also identified several references to tax protestor terms in the Document 6209.

The IRM and Document 6209 are published in hard copy format for internal IRS use. The IRM and Document 6209 are also published on the IRS Intranet, except for parts that are for internal IRS use only because they contain sensitive information. IRS management in Publishing Services and a program analyst in Information Systems informed us that Document 6209 is updated annually, and the IRM is updated on a case-by-case basis to meet the needs of the IRS divisions requesting the change. Each IRS operating division (e.g., Examination, Collection, and Criminal Investigation) is responsible for submitting updates to Publishing Services and Information Systems to revise procedures or references to its section of the IRM or Document 6209 that relates to its operation.

Program analysts in each operating division informed us that they submitted revisions to remove the ITP reference in the IRM and Document 6209 to Information Systems and Publishing Services in late 1998 and early 1999. They also provided written documentation to support that many of the changes were made. Timing may be the primary cause the IRM on the Intranet and Document 6209 had not been updated. Eliminating the remaining references to ITPs in these two instruction manuals could help ensure IRS employees do not follow obsolete ITP guidelines.

Various IRS Computer Systems

In addition to the IRS' main computer files, the IRS uses various nationwide computer systems to control

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In most instances, the ITP codes were removed from various other nationwide computer systems that control inventory workloads. We identified isolated records that contained references to the ITP designation on these systems.

inventory workloads for employees. We reviewed the following nationwide computer systems for ITP designation codes in the field offices we visited: the Audit Information Management System (AIMS) in Examination Division; the Criminal Investigation Management System (CIMIS) in Criminal Investigation Division; and the Unified Systems for Time and Appeals Records (uniSTAR) in Appeals Division.

In most cases, the ITP codes were removed. However, we identified isolated records that contained references to the ITP designation on some of these systems. We brought these records to IRS management's attention and they immediately removed the ITP designations. The IRS offices we visited did not have documentation of why the ITP designations were on the systems, so we could not determine why the ITP designations still existed. Because these isolated occurrences were found on nationwide computer systems, the potential exists that this could occur in other field offices.

The Acting Chief Operations Officer and various IRS National Directors issued preliminary instructions to eliminate all ITP references on the IRS' computer systems. Eliminating any remaining ITP designations or similar designations from taxpayers' records on the various other computer systems could help to ensure employees comply with the RRA 98 § 3707 to prevent designating taxpayers as ITPs.

Recommendation

1. The IRS should monitor the remaining changes to remove the ITP designations from the IRM, Document 6209, and various IRS computer systems to ensure they are implemented timely and properly.

Management's Response: All IRS offices have been asked to certify that ITP designations have been removed or destroyed by September 30, 1999. The IRS plans to remove all references to ITPs and tax protestors

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found in the IRM on the Intranet and in printed materials.

The Internal Revenue Service Should Ensure the Newly Proposed Designations for Frivolous Nonfilers Will Comply with the Restructuring and Reform Act of 1998

The IRS has various nonfiler programs to determine if taxpayers are filing returns. However, IRS programmers advised us that none of the programs designate taxpayers permanently as nonfilers on the IRS' main computer files and, therefore, are not applicable to this RRA 98 provision. If taxpayers do not file or pay taxes for more than one tax period, the IRS places a code (repeater code) on their IRS account. The IRS' procedures are designed so that the repeater code is automatically removed after the taxpayer has filed and paid all of his or her taxes for two consecutive years.

We reviewed the initial plans for a new program the IRS is implementing to identify certain segments of nonfilers.

The IRS is currently developing a program (Frivolous Return Program) designed to identify those taxpayers who intentionally do not file returns or file substantially incorrect returns, and give a frivolous argument for not filing an acceptable tax return. An example of a frivolous argument would be that salaries and wages are not income within the meaning of the Sixteenth Amendment of the United States Constitution, which grants the Congress the power to collect taxes.

This program to designate taxpayers as frivolous nonfilers had not been implemented at the time of our audit, and only the initial plans were available for our review. We are planning an audit to evaluate the program once it is implemented to determine if it meets the intent of the RRA 98 § 3707.

The current plans for this program are to designate these taxpayers as frivolous nonfilers based on the specific reasons the taxpayers use for failing to comply with their

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tax return filing requirements. The IRS previously identified 28 reasons or arguments that these taxpayers commonly use for not filing an acceptable tax return. The Tax Court has ruled that these arguments are not legitimate reasons for not filing tax returns. The proposed, new designations could be an effective use of IRS resources for addressing non-compliance among these taxpayers. In addition to designating these taxpayers based on the 28 arguments, the current plans include:

- Developing education tools to reach out to this taxpayer population and provide education about the proper filing of returns.
- Centralizing processing for frivolous returns in one IRS service center to ensure consistent treatment of these taxpayers.
- Revising the document “Why Do I Pay Taxes?” (Publication 2105) to eliminate references to ITPs.
- Programming IRS computer systems to cause future returns filed by the taxpayer to be closely reviewed for frivolous arguments before the IRS accepts the return.
- Programming IRS computer systems to prevent the issuance of refunds that the taxpayer may not be entitled to receive based on the filing of a frivolous return.

While the plans for the new Frivolous Return Program could be an effective way to identify and correct nonfiling trends, the IRS needs to be careful that the new program complies with the RRA 98 § 3707.

While we could not review the program at this time, the plans for designating taxpayers as frivolous nonfilers could be seen as being similar to the ITP designation. The IRS should closely monitor the further development and implementation of these designations to ensure that innocent taxpayers are not erroneously labeled. The IRS should also ensure that the planned computer monitoring program for these frivolous nonfiler designations is implemented. This computer monitoring program would automatically remove the frivolous nonfiler

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designation once the taxpayer files valid tax returns and pays all taxes shown on the returns for two consecutive years. The computer monitoring program is planned for implementation in the year 2000.

IRS management informed us that designations for frivolous nonfilers are needed to enable the IRS to identify trends in taxpayers' behavior and develop targeted outreach efforts to educate taxpayers.

Recommendation

2. The IRS should monitor the planning and implementation of the newly proposed frivolous nonfiler designations and the frivolous nonfiler monitoring program (Frivolous Return Program) to ensure they meet the intent of the RRA 98 § 3707.

Management's Response: Implementation efforts are continuing for the Frivolous Return Program and are available for review. In addition, the IRS is still finalizing decisions to consolidate Service Center program activities into one location.

Office of Audit Comment: Subsequent to the completion of our review, IRS management determined that the Frivolous Return Program would not include the 28 taxpayers' arguments for not filing an acceptable return. We will continue to monitor the implementation plans for the Frivolous Return Program during our future audits of this area.

Conclusion

The IRS has substantially complied with the RRA 98 § 3707 by removing the ITP designations from its main computer files. Also, in the eight field offices we visited, employee interviews and reviews of taxpayers' case files showed that employees generally were not referring to taxpayers as ITPs, and were

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ignoring ITP designations that were present on various other computer and paper files. The IRS also took the initiative to implement further actions to ensure taxpayers are not labeled as ITPs.

However, the additional steps taken by the IRS to remove the ITP designations from instruction and reference manuals, and from various other computer systems, should be monitored to ensure they are implemented timely and properly. Also, the IRS should ensure the newly proposed frivolous nonfiler designations and its monitoring program meet the intent of the RRA 98 § 3707.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to evaluate the Internal Revenue Service's (IRS) compliance with the provisions of the IRS Restructuring and Reform Act, Pub. L. No. 105-206, 112 Stat. 685 (1998) to stop designating taxpayers as Illegal Tax Protestors (ITP). More specifically, the sub-objectives were to determine whether the ITP designation was eliminated from the Individual and Business Masterfiles and was being disregarded in the field offices, and the nonfiler designation was being monitored. We also evaluated the IRS' plans for a new taxpayer designation to determine if the designation meets the intent of the RRA 98.

The specific section of the IRS Restructuring and Reform Act Pub. L. No. 105-206, 112 Stat. 685 (1998) which refers to ITPs is § 3707, and future references to this section will be noted as the RRA 98 § 3707.

Scope and Limitations

We conducted this review from January 1999 through May 1999, in the IRS' National Office, the four regional offices, and eight IRS field offices. We obtained information by interviewing IRS employees, reviewing a limited judgmental sample of cases in six field offices, and reviewing various IRS guidelines. We performed an analysis of files maintained on the IRS' main computer files related to ITPs and looked at various other computer systems to determine if taxpayers were still being designated as ITPs.

We conducted a limited review of the plans for a proposed program that will monitor frivolous nonfiler noncompliance. Because the program was only in the developmental stage, we only reviewed the implementation plans. Also, we obtained limited information on the IRS program that identifies taxpayers who do not file returns or pay taxes for more than one tax period as repeaters. We did not perform audit tests of this program due to the magnitude of the program.

We conducted the following audit tests to accomplish the objective:

- I) Interviewed management to identify areas of concern and any policy or procedural changes that were implemented.
 - a) Obtained and reviewed national, regional and field office directives pertaining to the designation of taxpayers as ITPs within the following divisions:
 - Compliance (overall)
 - Examination

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- Collection
 - Criminal Investigation
 - Appeals
 - Customer Service
 - General (All Employee Memoranda, etc.)
- b) Interviewed the Section 3707 Task Force to identify any risk or significant issues they had identified in the area.
- c) Obtained and reviewed any reports (status reports, etc.) available from the Section 3707 Task Force.
- d) Obtained information about the IRS' process to track nonfiler compliance so that the IRS will know to remove nonfiler designations when the taxpayer has filed and paid taxes for two consecutive years.
- II) To identify the population of ITPs and Potentially Dangerous Taxpayers (PDT) on the Individual and Business Masterfiles before the ITP designation was eliminated on January 15, 1999, we:
- a) Obtained a Masterfile extract in December 1998 of all accounts with an ITP designation.
- b) Obtained a Masterfile extract in December 1998 of all accounts with a PDT designation.
- c) Obtained a count of PDTs from the PDT Database maintained by the Treasury Inspector General for Tax Administration (TIGTA) National Employee Protection Coordinator (NEPC) and compared it to the volume of PDTs on our extract to validate the PDT extract.
- d) Validated the ITP designation extract data by comparing it to the IRS' Integrated Data Retrieval System (IDRS).
- III) To ensure that the ITP designation was removed from the Individual and Business Masterfiles, we:
- a) Obtained a Masterfile extract for the week of January 24, 1999, of all accounts with the ITP designation.
- b) Followed up [REDACTED] 1 [REDACTED] s from the results of Test "III.a" by researching the IDRS [REDACTED]

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- c) Took a statistical sample of 100 accounts (used 95 percent confidence level, ± 2 percent precision and a 5 percent error rate) which had an ITP designation prior to January 15, 1999, and performed IDRS research after January 15, 1999, to confirm that the ITP indicator had been removed. Also, determined if any new indicator replaced the ITP indicator.
- IV) To ensure that taxpayers with an ITP designation on the Individual and Business Masterfiles, prior to January 15, 1999, were not simply reclassified as PDTs, we:
- a) Obtained a Masterfile extract for the week of January 24, 1999, of all accounts with a PDT designation.
- b) Compared the volume of PDTs prior to the elimination of the ITP designation to the volume of PDTs after the elimination of the ITP designation to determine if the volume of PDTs drastically increased.
- c) Interviewed the TIGTA NEPC to determine if a large number of requests to establish taxpayers as PDTs was received around the time of the ITP elimination.
- d) Obtained a count of PDTs from the PDT Database maintained by the TIGTA NEPC and compared it to the volume of PDTs on our extract to validate the PDT extract.
- V) To ensure that IRS personnel were not using ITP designations or referring to taxpayers as ITPs, we:
- a) Conducted interviews with 112 IRS management officials and 11 employees in 8 judgmentally selected IRS field offices to determine whether they had documents or databases with ITP designations. The employees worked in the following IRS divisions:
- Examination
 - Collection
 - Criminal Investigation
 - Appeals
 - Customer Service
- b) Determined if any stand alone IRS field office database systems still made references to taxpayers as ITPs and determined how these were being used by the field offices.

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- c) Determined if the IRS field offices planned to delete the ITP designations from their systems.
- d) Determined if training related to the ITP provisions of the RRA 98 § 3707 was provided to IRS employees.
- e) Determined if any taxpayers' complaints were received since July 22, 1998, on this issue in six of the offices we visited. [REDACTED] 1 [REDACTED]
[REDACTED] 1 [REDACTED]
- f) Reviewed a judgmental sample of 254 cases previously identified as ITP cases. Cases were identified from our computer extract or from field office inventories.
 - 1) Reviewed case file documentation, such as the case history and correspondence to the taxpayer, to determine if employees referred to taxpayers as ITPs after July 22, 1998.
 - 2) Discussed exception cases with IRS management in the offices visited.
- VI) Reviewed the process used to eliminate ITP designations on data shared with state agencies in the three districts we visited that had agreements to share ITP data with the states.
 - a) Determined if and when the IRS stopped sharing ITP data.
 - b) Determined if and when the IRS requested that any ITP data previously shared be returned.
- VII) Determined if related national guidelines, the Internal Revenue Manual and the handbook, *ADP and IDRS Information* (Document 6209), have been updated to eliminate references to ITPs.
- VIII) Determined the status of a proposed new system for monitoring non-compliance.
 - a) Met with IRS Section 3707 Task Force management and obtained the latest status of this proposal.
 - b) Reviewed the plans for the program to determine if the proposal appears to meet the intent of the RRA 98 § 3707 in terms of employees no longer designating taxpayers as ITPs, and IRS removing nonfiler designations from its main computer files once the taxpayer files valid tax returns and pays all taxes shown on the returns for two consecutive years.

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Appendix II

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Appendix III

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Regional Commissioner, Northeast Region
Regional Commissioner, Southeast Region
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Director, Northern California District
Director, Ogden Service Center
Director, Rocky Mountain District
Director, Virginia-West Virginia District

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Appendix IV

Management's Response to the Draft Report



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

September 28, 1999

OFFICE OF TREASURY
INSPECTOR GENERAL
RECEIVED

1999 SEP 28 P 4:41

FOR TAX ADMINISTRATION

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR
TAX ADMINISTRATION

FROM: Charles O. Rossotti 
Commissioner of Internal Revenue

SUBJECT: Draft Audit Report - The Internal Revenue Service Is Addressing
the Use of Illegal Tax Protestor and Nonfiler Designations

Thank you for giving us the opportunity to review and comment on your draft report, "The Internal Revenue Service is Addressing the Use of Illegal Tax Protestor and Nonfiler Designations," and its recommendations.

We were pleased with your findings that the Internal Revenue Service (IRS) had actions underway to fully comply with the Restructuring and Reform Act provisions that prohibit the use of the "illegal tax protestor" (ITP) designation. The law requires that we remove any existing designations in the individual master file and disregard any other existing designations, such as those on paper records.

We have continued our efforts to remove the ITP designation from our systems and manuals since you concluded your review activity. I would like to update you on our progress. We have implemented procedures to ensure that individuals who have a filing requirement and have filed valid, but frivolous returns, as determined under Internal Revenue Code (IRC) Section 6702, or a return formerly designated as ITP will be posted to the master file with a Transaction Code (TC) 150, not a TC 148. These returns will receive no other markings. No actions will be taken to unpost subsequent returns or freeze refunds for valid return filings, regardless of the argument used. Your report, on pages 9 and 10, addresses an earlier proposal to designate taxpayers based on 28 arguments. While other components of this plan were approved, the recommendation for use of the 28 arguments was not implemented.

Additionally, we have established procedures to identify individuals, formerly designated as ITPs, who have a filing requirement and have filed non-valid documents purporting to be returns, or have provided correspondence indicating their unwillingness to file based on a frivolous argument. These procedures provide for posting to master file with a designation reflecting the nonfiler status. This posting will cause subsequent

The Internal Revenue Service Is Addressing the Use of the Illegal Tax Protestor and Nonfiler Designations

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year returns to unpost and refunds to freeze, but only until the taxpayer files valid returns for 2 years.

IRS employees have been prohibited from using Special Project Code (SPC) 085 on the AIMS and ERCS databases. This is no longer a valid SPC. IRS employees have also received written instructions to stop referring to taxpayers as ITPs and to ignore any and all ITP indicators on internal documents. All IRS offices have been asked to certify that ITP designations have been removed and/or destroyed by September 30, 1999.

Our comments on the specific recommendations in this report are as follows:

IDENTITY OF RECOMMENDATION #1

IRS should monitor the remaining changes to remove the ITP designations from the IRS instruction manuals and from various IRS computer systems.

ASSESSMENT OF CAUSE(S)

Section 3707 of the Internal Revenue Service Restructuring and Reform Act (RRA), Pub. L. No. 105-206, 112 Stat. 685 (1998), prohibits IRS from designating a taxpayer as an ITP. The designations have been deleted from IRS central computer files. We also issued instructions to delete all ITP databases and ancillary systems containing ITP designation. However, the instructions were issued after the Treasury Inspector General for Tax Administration (TIGTA) finished its audit and thus the corrective action of removing the ITP label on some of the ancillary files may have occurred after the audit sampling.

With respect to the removal of the ITP reference in the instruction manuals, IRS took the initiative to remove not only the references to ITP but also to tax protestor. We agree with the draft report that the timing of the request for removal of the ITP references was the major reason why some printed instruction manuals still contain such references.

CORRECTIVE ACTIONS

All IRS offices have been asked to certify that ITP designations have been removed or destroyed by September 30, 1999.

No action is required for deleting ITP designations from computer files.

IRS will remove all references to ITP and tax protestors found in Internal Revenue Manuals on the Intranet. References found in printed instruction manuals will be deleted as they are located.

**The Internal Revenue Service Is Addressing
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IMPLEMENTATION DATE:
PROPOSED February 1, 2000

RESPONSIBLE OFFICIAL
Assistant Commissioner (Examination)

CORRECTIVE ACTION(S) MONITORING PLAN
The actions will be added to IRS' master RRA action plan and monitored by the RRA Executive Steering Committee.

IDENTITY OF RECOMMENDATION #2
IRS should monitor the planning and implementation of the newly proposed frivolous nonfiler designations and the frivolous nonfiler computer monitoring program to ensure they meet the intent of RRA.

ASSESSMENT OF CAUSE(S)
The recommendation arose as a result of TIGTA being unable to assess the effectiveness of the proposed frivolous nonfiler designation and the frivolous nonfiler computer monitoring program as they have yet to be implemented.

CORRECTIVE ACTIONS
Our implementation efforts have continued since you concluded your review activity and we invite you to contact us to review our most current plans for the Frivolous Return Program. We are still finalizing decisions to consolidate Service Center program activities into one location and hope to implement this during FY 2000.

IMPLEMENTATION DATE:
PROPOSED October 1, 2001

RESPONSIBLE OFFICIAL
Director, Rocky Mountain District

CORRECTIVE ACTION(S) MONITORING PLAN
There is no corrective action to be monitored. However, the implementation of the proposed plans will be monitored by the RRA Executive Steering Committee as are the actions of other RRA provisions.

If you have any questions, please call me or members of your staff may call Maria Hwang at (202) 622-3448.